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IN THE

Supreme Court of the United States

October Term, 1975
No. 75-297

In the Matter of

ARTHUR CHARLES AHLSWEDE and
DOROTHY AHLSWEDE,

Bankrupts.

RICHARD W. STEBBINS, Trustee,

Petitioner,

vs.

CROCKER-CITIZENS NATIONAL BANK,

Respondent.

Respondent's Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Opinions Below.

The opinion of the Court of Appeals for the Ninth Circuit is not yet officially reported, but it, as well as the unreported order on review of the District Court for the District of Nevada, and the Order of the Referee in Bankruptcy is appended to the Petition for a Writ of Certiorari.

Jurisdiction.

Respondent does not question the jurisdiction as set forth in the Petition.

Question Presented.

May the Bankruptcy Judge (Referee) subordinate the valid claim of an unsecured creditor under the pretext of doing equity, when the circumstances present no evidence of inequitable conduct?

Statement of the Case.

The facts in this case are not in dispute and have been stipulated by the parties. (Attached herein as Appendix.) Petitioner's condensation of these facts is accepted only as to the terms of the trust and the fact that the bankrupt was indebted to it. However, it is total speculation to assert that the bankrupt's percentage share of the trust assets will be sufficient to repay his indebtedness, even assuming he survives to the date of final distribution of the Trust. Should the bankrupt die, and the trustee be faced with claims of a new class of beneficiaries not parties to this proceeding, the District Court notes critically that "there is no assurance that the Bankrupt will not die before the spendthrift trust is fully distributed, and thus no assurance that Crocker's security for payment of the obligation is adequate." (Petitioner's Brief for Certiorari at Appendix, 12.)

As to the subordination of respondent's claim (*Id.* at 4), it is important to note that the Referee found not a hint of inequitable conduct of any kind by the parties involved. Rather, the Referee declared,

> "It is not necessary that there be fraud or other inequitable conduct . . . It is sufficient that there is inequity in the situation." (*Id.* at Appendix, 5.)

Respondent then petitioned the United States District Court for the District of Nevada for review of the Referee's Order and the District Court entered its order reversing the Referee on April 26, 1973. Among the Court's major findings were the following:

1. The Bankruptcy Court is not vested with the power to adjust and order claims merely because of a general feeling of what is fair and unfair. (*Id.* at 11.)
2. There must be a showing of fraud or other inequitable conduct before the claim of the bank can be subordinated and no such showing is presented by the facts of this case. (*Id.* at 11.)

The United States Circuit Court of Appeals for the Ninth Circuit affirmed the decision of the District Court, finding no equitable grounds to support the Referee's decision to subordinate Respondent's claim. (*Id.* at 14-24.)

ARGUMENT.

1. This Case Does Not Present a Question of Law Upon Which There Is Disagreement Among the Circuits.

The issues presented by these facts are adequately decided by established precedent.

Petitioners argue that the Bankruptcy Court as a court of equity is guided by equitable principles which demand a sensible construction of the Bankruptcy Act and require "that substance . . . not give way to form, that technical considerations . . . not prevent substantial justice from being done." (Petitioner's Brief for Certiorari at 10.)

Respondents agree that the axiom is sound, but Petitioner's application is deficient.

First, while the Bankruptcy Court may be a Court of Equity, neither it nor any other Court of Equity may disregard a clear mandate of law. While equity demands a "sensible construction" be placed on the law, the core of equity is still the law; as Professor Collier has noted,

> "Where the Bankruptcy Act is silent, equitable principles will govern. But the equitable powers of the Court are to be exercised within the limits laid down by the Act and subject to and consistent with any specific provisions contained in it." *Collier on Bankruptcy* §2.09, at pp. 175-6.

It has been stipulated that respondent is a trustee of a validly created spendthrift trust, a legal entity recognized by applicable law. Respondent is not a secured creditor within the meaning of §1(28) of the Bankruptcy Act. The Act provides no legal basis for subordination of respondent's claim absent fraud or some other inequitable conduct, and it is accepted that in the dealings between the bankrupt and respondent there was not a hint of fraud or other inequitable conduct.

Petitioners seek to subordinate respondent's claim solely because respondent may pay the bankrupt his percentage from trust funds at a later date of distribution. To authorize subordination in such a context would elevate equity above the law and represents but an attempt to redefine and judicially reorient the distribution scheme provided by the Bankruptcy Act. The Circuit Court so held. (Petitioner's Brief, *supra*, at 18.) The bankrupt is not the trust, and this distinction is not a mere legal technicality. The bankrupt is only one of four beneficiaries of the trust, has no present right to any portion of the trust corpus, and must survive until distribution in order to personally share at all in trust proceeds.

Second, in order to do equity, a Court's action must *in fact* be guided by equitable principles. In each of the cases supporting the subordination of a claim in bankruptcy, this Court has first required a showing of fraud or some other inequitable conduct. *Prudence Realization Corporation v. Geist*, 316 U.S. 89 (1941), *Heiser v. Woodruff*, 377 U.S. 726 (1945), *Pepper v. Litton*, 308 U.S. 295 (1939). (See Petitioner's Brief, *supra*, at Appendix 18-20.)

This requirement is not merely a rule of convenience, but a substantive principle. In the classic set of facts mandating equitable relief the mercantile creditor body finds itself at a severe disadvantage as a result of the inequitable conduct of a competing insider creditor, requiring that the inequitable advantage be eliminated.

The facts of this appeal present no such demand for equitable relief. It is stipulated that there is no inequitable conduct of which to complain. Petitioner instead asserts that the bankrupt's other creditors were prejudiced by the filing of respondent's bona fide claim. Yet these creditors freely chose to become the bankrupt's unsecured creditors with at least constructive knowledge of respondent's existence as an unsecured creditor. Respondent's civil action, filed in the Superior Court of the County of Los Angeles on June 5, 1970, and whose claim filed herein contains the complaint of said action, long antedated the filing of these proceedings on April 7, 1971.

Petitioner asserts as a separate element of prejudice the law governing spendthrift trusts. (*Id.* at 7.) Similar charges may be leveled against the recognition of state exemption laws, priorities granted certain classes of claims in bankruptcy, the eligibility of only certain people to file for bankruptcy, the use of summary procedures, and a host of other "quirks" of the law. The response to each is identical—it is within the province and power of Congress to determine the scope and policy of the law. In this case, it is within the province and power of Congress in providing for the retention of state rules of property law (*Id.* at Appendix 21.)

2. Response to Petitioner's Contentions.

Petitioner cites two contentions in support of his appeal for reversal of the decision of the Ninth Circuit Court of Appeals.

First, that the cases cited by the Court of Appeals are not analogous to the present situation. However, petitioner has failed to accurately characterize the facts.

The bankrupt has not had full use of trust assets but received loans from his father, who assigned the notes to the trust. The trust has always dealt at arm's length with the bankrupt, and obtained a state court judgment against the bankrupt over the bankrupt's opposition.

Moreover, it is not true that the bankrupt alone stands to benefit from allowance of respondent's claim. The trust would be augmented, but the bankrupt (who is but one beneficiary) must survive to the date of distribution in order to receive his percentage thereof. In addition, the trust share of each of the four beneficiaries contains a contingent 25% interest in the bankrupt's notes, so that each one stands to gain or lose on the outcome of the Bankruptcy Judge's decision.

As to the case law cited by the Court of Appeals, respondents believe that it is directly applicable to the facts presented. Petitioner's claim of inequity arises because spendthrift trusts are recognized as a valid legal entity according to applicable law. If it were considered *per se* inequitable to borrow from the trust or the decedent trustor, simply because the borrower was also a potential beneficiary of the trust, then it seems evident (a fortiori) that all loans to corporations made by officers, directors, or shareholders should be construed as equally inequitable.

Second, petitioner contends that the equitable power is ample to subordinate a claim in these circumstances. But not one case supports the application of equitable subordination absent inequitable conduct.

This Court has limited application of the principle of equitable subordination, in cases involving loans to corporations by officers, directors, or shareholders, to circumstances involving patently inequitable conduct

even though these lenders (claimants) almost always are the same parties whose lack of managerial expertise has caused or aggravated the financial terminal illness of the borrower but whose loans usually gave to debtor an aura of financial stability thus encouraging mercantile creditors to deal with the debtor on an open account basis to their later detriment.

Frasher v. Robinson, 458 F.2d 492 (9th Cir. 1972), Cert. denied 409 U.S. 1009 (1972);

In re Calpa Products Company (E.D. Pa., 1965), 249 F.Supp. 71, Aff'd 354 F.2d 1002 (3rd Cir., 1965), Cert. denied sub nom.,

Grassberger v. Calissi, 383 U.S. 947 (1966), Reh. denied 384 U.S. 934 (1966).

This Court's requirement of inequitable conduct, by the way, would support subordination of the claims in petitioner's "projected case". (Petitioner's Brief for Certiorari at 11-13.)

Petitioner, it is submitted, has shown no division among the circuits on this issue, nor has petitioner shown a good cause, or even a good reason, for this Court to assume jurisdiction in this matter.

Conclusion.

For the reasons set forth above, it is respectfully submitted that the petition for a writ of certiorari be denied.

Dated: September 26, 1975.

Respectfully submitted,

RICHARD R. CLEMENTS,
Attorney for Respondent.

Of Counsel:
VON HERZEN, CATLIN, REINJOHN & CLEMENTS.

APPENDIX.

Stipulation Re Objections to Claim of Crocker Citizens National Bank.

United States District Court, for the District of Nevada.

In the matter of Arthur C. Ahlswede and Dorothy Ahlswede, Bankrupts.

In Bankruptcy BK-R-71-198-199.

Filed: Dec. 13, 1972.

Richard W. Stebbins, Trustee in Bankruptcy, Crocker Citizens National Bank, Claimant and Arthur C. and Dorothy Ahlswede, Bankrupts, by and through their respective counsel of record, hereby and herewith stipulate to the following matters of fact and procedure pertaining to the claim heretofore filed by and on behalf of Crocker Citizens National Bank and the subsequent objection of the Trustee thereto:

I

STATEMENT OF FACT

Crocker Citizens National Bank (as successor to Citizens National Bank) is the Trustee under a written declaration of trust executed by A. Charles Ahlswede, Trustor, dated March 6, 1962, and subsequent amendments executed thereto. That said declaration of trust and said amendments are attached hereto, are marked as Exhibits "A" through "D", respectively, and said declaration of trust and each amendment is hereby and herewith incorporated herein by reference. The amend-

ments to said declaration of trust are dated November 14, 1963, January 21, 1965, and February 24, 1965. The Trustor, A. Charles Ahlswede, died on March 20, 1969.

On or about April 12, 1965, the Bankrupt herein, A. Clark Ahlswede, was indebted to the Commercial Department of Crocker Citizens National Bank in the principal sum of $50,000. Said above-mentioned obligation was evidenced by a renewed Promissory Note dated July 1, 1968, payable on demand or 90 days from the date thereof wherein the maker thereof was the Bankrupt herein and payee was the Claimant. It has heretofore been admitted herein that said Note is complete and regular on its face, that all signatures, endorsements, and assignments are genuine, and that said Note was duly delivered to Claimant. That a true copy of said Note is attached hereto, is marked as Exhibit "E", and is incorporated herein by this reference. As a further inducement, to the payee, to grant said proposed extension of credit, said renewed Promissory Note was secured by a pledge of all the trust assets of the Trust Estate of the now deceased A. Charles Ahlswede, on or about April 12, 1965. That, subsequent to the execution thereof, the Bankrupt, A. Clark Ahlswede, did not make any interest payments as they became due thereon. Claimant, as Trustee of the Trust Estate of A. Charles Ahlswede, advanced to the Commercial Department of Claimant interest when due on said Note (in order to protect and preserve said pledged collateral and its collateral position). Claimant/Trustee advanced and paid the following interest payments, to wit:

Date of Payment	Amount of Interest Paid
July 6, 1965	$1,932.64
November 22, 1965	687.50
January 19, 1966	695.14
April 25, 1966	726.74
August 23, 1966	798.61
October 27, 1966	812.40
January 12, 1967	862.50
April 21, 1967	843.75
June 28, 1967	821.53
October 13, 1967	789.93
December 27, 1967	798.61
March 29, 1968	875.00
June 28, 1968	916.32
November 27, 1968	979.51

Due demand was made upon the Bankrupt, from time to time, to make said interest payments, but the Bankrupt failed and refused to make any payments. On January 20, 1969, the Commercial Department of Crocker Citizens National Bank demanded payment, in full, of said renewed Promissory Note by February 28, 1969. As of April 18, 1969, the Bankrupt had made no payments on principal, or interest, to said Commercial Department of Crocker Citizens National Bank and on May 2, 1969, the Trustee of the Trust, pursuant to the pledged obligation of the Trust Estate, remitted to the said Commercial Department the sum of $52,303.44. Said sum represented $50,000.00 in un-

paid principal and $2,303.44 unpaid interest. That, on or about said date of payment, the Bankrupt thereby became indebted to the Claimant on said renewed Promissory Note by the reason of the payment, in full, of said Note by the Claimant herein. On April 10, 1970, the amount of $64,843.62 plus interest thereon had not been paid on said renewed Promissory Note dated July 1, 1968. That Claimant thereupon initiated an action to recover the same (see infra).

That, in addition, said Bankrupt was the maker of a Promissory Note dated September 1, 1964, in the sum of $7,203.96 with interest thereon at the rate of 4% per annum. That the genuineness of said Note and all endorsements thereof, the fact that the same is complete and regular upon its face, and the delivery thereof, has been heretofore admitted. That a true copy of said Note is attached hereto, is marked Exhibit "F", and is incorporated herein by this reference. That, thereafter, said Promissory Note was added to the corpus of the A. Charles Ahlswede Trust. Said Note was payable within 5 years or upon the date of distribution of the A. Charles Ahlswede Trust, whichever was earlier. That, pursuant to the terms of said note, the Bankrupt promised to pay reasonable attorney's fees in the event the payee, or his assigns, was required to initiate suit to recover the same. That said Note was assigned on March 24, 1965 to Claimant.

On September 15, 1969, the Claimant herein demanded payment in full of the principal and interest due on said Note. That, to date, the Bankrupt has made no payment of interest and has made no payment of principal on said Note.

That, in addition, on September 1, 1964, the Bankrupt executed an additional note for the sum of $14,-

593.79 with interest at 5% per annum payable to A. C. Ahlswede. The genuineness, the fact that the note is complete and regular upon its face, the delivery and the genuineness of the endorsements have all been admitted by all parties herein. Said Note was payable within 5 years or upon the date of distribution of the A. Charles Ahlswede Trust, whichever was earlier. Further, under the terms of said Note, the Bankrupt promised to pay reasonable attorney's fees in the event the payee or his assigns, were compelled to initiate suit for the payment thereof. That a true copy of said Note, and its reverse side, is attached hereto, is marked Exhibit "G", and is incorporated herein by this reference.

That, on or about March 24, 1965, said Note (Exhibit "G") was added to the corpus of the Claimant's Trust by assignment. On September 15, 1969, the Claimant demanded payment in full of the principal and interest due on said Note. That the Bankrupt has made no payment of principal, or interest, on said Note to date.

Further, on September 1, 1964, the Bankrupt executed a further Promissory Note in the sum of $1,-504.35 plus interest at the rate of 5% per annum, payable to A. C. Ahlswede. That the genuineness of said Note, the fact of its delivery, the fact that the same is complete and regular upon its face, and the genuineness of the endorsements thereon, have been admitted by all parties. Said Note was payable within 5 years or upon the date of the distribution of the A. Charles Ahlswede Trust, whichever was earlier. That a true copy of the front and reverse sides of said Note is attached hereto, is incorporated by this reference, and is marked as Exhibit "H".

Under the terms of said Note (Exhibit "H") the Bankrupt promised to pay reasonable attorney's fees in the event that the payee, or his assigns, brought suit for the payment thereof. That, on or about March 24, 1965, said Note (Exhibit "H") was assigned to the Claimant. That, on September 15, 1969, the Claimant demanded payment in full of the principal and interest due on said Note. That the Bankrupt has not repaid any principal, and has not repaid any interest, on said Note from the date of its inception.

Further, the Bankrupt executed an additional Promissory Note dated September 1, 1964, for the principal sum of $24,350.00 with interest at the rate of 4% per annum payable to A. C. Ahlswede. The genuineness, the fact that said Note was and is complete and regular upon its face, the fact of the delivery and the further fact of the genuineness of the endorsements, have been admitted by all parties herein.

Said Note is payable within 5 years or upon the date of the distribution of the A. Charles Ahlswede Trust, whichever occurred earlier. That a true copy of said Note is attached hereto, is marked as Exhibit "I", and is incorporated herein by this reference. Under the terms of said Note (Exhibit "I") the Bankrupt promised to pay reasonable attorney's fees in the event the payee, or his assigns, initiated suit for the payment thereof.

That, on or about March 24, 1965, said Promissory Note (Exhibit "I") was assigned to the Claimant. That each of said Promissory Notes (Exhibits "E" through "I", inclusive) were additions to the corpus of the Trust Estate of the Claimant Trust.

On September 15, 1969, Crocker Bank demanded payment in full of the principal and interest due on said

Note (Exhibit "I"). That the Bankrupt has failed to pay any payment of principal, or interest, on said Note.

That, on June 5, 1970, Claimant herein filed its action entitled "Crocker Citizens National Bank, etc., vs. A. Clark Ahlswede, etc." in Superior Court of the State of California for the County of Los Angeles, Case No. 978504. That a true copy of plaintiff's complaint (without attached Exhibits) in that matter, is attached hereto, is marked as Exhibit "J", and is incorporated herein by this reference. That said action seeks recovery upon each of said Promissory Notes and upon the monies advanced pursuant to the above-stated collateral agreement. That said matter is pending and awaiting trial.

That, in the interim, Claimant has made a partial distribution of the Trust pursuant to the terms thereon. Further, pursuant to the express terms of the Trust, Claimant has applied the amount of said distribution to said collateral loan which appears in Claimant's complaint (Exhibit "J") as having a balance of $64,-843.62. That, in addition, the income of the corpus of said Trust is being distributed monthly to said Trust beneficiaries. Pursuant to the express provisions of said Trust, the income allocated to the Bankrupt is being applied, by the Claimant, to said indebtedness. That the principal balance, on the collateral Note, is the present sum of $22,292.74 and interest thereon is current. All of the remaining Notes remain unpaid, both as to principal and interest.)

The Claimant further alleges that it is entitled to reasonable attorney's fees in the sum of $11,750.00 together with costs in the sum of $237.04.

II

STIPULATION RE PROCEEDINGS

1. It is stipulated that the matter of the Trustee's objection, to the claim of Crocker Citizens National Bank, may be submitted upon the above facts, together with any further evidence that the Referee in Bankruptcy may require;

2. That each of the parties hereto stipulate that objections, of the Trustee, I through V, as filed herein on or about February 15, 1972, be, and they hereby are, withdrawn and that the sole remaining objection is that objection dated on or about April 11, 1972, entitled "Additional Objection to Allowance of Claim of Crocker Citizens National Bank" filed herein by the Trustee in Bankruptcy.

Dated: September 31, 1972.

STEWART, HORTON & McKISSICK LTD.
By /s/ Richard Horton
RICHARD HORTON
Attorneys for ARTHUR CLARK AHLSWEDE and DOROTHY AHLSWEDE, Bankrupts

/s/ Bruce D. Roberts
BRUCE D. ROBERTS, Attorney for RICHARD STEBBINS, Trustee

/s/ Richard R. Clements
RICHARD R. CLEMENTS, Attorney for CROCKER CITIZENS NATIONAL BANK, Claimant